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DRAFT CHAPTER 98 OF TAX CODE

**SOME BRIEF ANALYSES OF DRAFT
CHAPTER 98 INFLUENCE ON SMALL AND
MEDIUM ENTERPRISES ACTIVITIES**

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INTRODUCTION

Changes concerning Chapter 98 “Simplified taxation system for small enterprises” (referred to as Chapter 98) proposed by the Ministry of Finance for introduction into the Tax Code approved by the Verhovna Rada in the first reading are mainly expected to result in positive influence on small and medium enterprises (SME) economic activity. In particular, issues related to specific tax legislation are to be addressed. Proposed measures are expected to aim at improving conditions of SME activity, eliminating of barriers for operation, and stimulating development of activities in official economy. It appears that projected tasks could be realized through measures undertaken in two main directions:

- Substantial improvement of overall tax system what would guarantee the achievement of desirable characteristics of tax legislation. Emphasis should be assigned to meeting principles and objectives of good taxation, namely: neutrality, equality, simplicity, stability, transparency and understandability, easy administration and control (one may refer to this requirements as to *theoretical principles of optimal tax policy*).
- Properly designed provisions related to SME activities, which would create favorable conditions for SME development and indirectly stimulate overall economic growth. Special consideration should apply to the analyses of particular legal solutions’ influence on SME savings efforts, productive investment, employment, human capital formation, elimination of administrative barriers, fair market economy competition creation (one may refer to as *economic effects of tax system structure*).

From the theoretic point of view, the idea of introduction of simplified and unified taxation for SME seems to satisfy most of mentioned goals. However, practical legal solutions suggested in the Chapter 98 appear to face some weaknesses. The critique applies to two major aspects of proposed provisions: tax base and tax rate definitions.

WEAKNESSES

1. Tax Base Weaknesses

- Chapter 98 distinguishes three categories of SME (depending on the legal form and level of turnover), which may become subject of simplified and unified tax regime¹. Diversified definition of taxpayers then results in application of respective two different forms of tax treatment. First, it leads to substantial progressivity, second creates unequal treatment of taxpayers in the framework of one wide group of economic units. In principle, to some extent it contradicts with the notion of simplified and unified tax regime for SME.
- Assignment to specific category of taxpayer depends on the level of turnover during the previous tax period (year). However, previous year achievements do not guarantee that an enterprise will generate turnover in the same range in current year. This weakness indirectly stems from the proposed taxpayer definition. Tax

¹ Point 15002: definition of subjects of simplified system.

obligations should depend on actual effects in order to take into account situation when turnover fluctuates over time.

- There is no unique, precise definition of place of economic activity for all categories of SME. It seems that defining it as “the place of registration” would prevent the possibility of misinterpretation.

2. Tax Rate Weaknesses

- Chapter 98 suggests two different tax rate regimes for units of SME, namely: fixed patent payment and percentage rate payment (which in addition foresees two alternatives: 6% + VAT compliance and 10% without VAT)². Such composition of tax rates creates the possibility of unequal tax treatment of SME. Furthermore, it adds to progressivity of tax regime. It may also cause barriers to subsequent development of SME as the increase in turnover is accompanied by the necessity to shift into another category, which is much more heavily taxed. In addition, combined with specific design of accounting reporting requirements it may be a measure, which would motivate trials to misreport the actual turnover in order to avoid shifts into another category. As a result tax evasion will be motivated.
- The value of due fixed patent payment is to be established by the local municipal authorities depending on the country’s region of economic unit activities. However, desirably tax system should apply to whole country and diversification between regions should not take place. Moreover, tax rate should not depend on arbitrary decision of authorities but be clearly defined in legislation. Only then it would ensure taxpayers certainty regarding their tax obligations.

CONCLUSIONS

Legal provisions suggested in Chapter 98 with respect to tax obligations, are expected to aim at the improvement of conditions for development of SME. The fact that the government recognizes the necessity to create more favorable conditions for SME activities by redesigning tax system represents progress in the framework of economic policy. Specific positive element should be underlined, which is the permission to participate in the foreseen simplified scheme providing that SME execute only cash settlements. It enables to define more precisely tax base, increases its quality and prevents erosion by means of mutual settlements and barter operations.

However, the project suffers from several weaknesses. While considering theoretical taxation principals the following shortcomings could be mentioned:

1. diversified tax treatment of different SME categories
2. relatively complicated system of taxpayer categories defining, taxation schemes, methods, and tax rates, which only to limited extent reflects the idea of unified tax regime
3. some provisions appear to be difficult to interpret and comply for taxpayer
4. does not satisfy the notion of simple and transparent legislation idea
5. tax scheme seems to be partially complex for administration, thus expensive in enforcement and difficult for the monitoring of tax compliance

² Point 15003: Simplified system forms.

6. system of patent value establishment leaves place for arbitrary authorities decisions

Suggested changes in legislation appear to bring the following economic effects:

1. structure of tax rates and definition of taxpayers categories would rather constrain the subsequent development of SME. It would be very “costly” for SME to overcome the level of turnover equal to 10 000 minimal wages as it is accompanied by substantial increase in due tax obligations
2. introduction of alternative possibility in the form of 10% rate accompanied by VAT exemption may affect VAT revenues
3. VAT exemption for some categories of taxpayers may result in their impossibility to use VAT credits and deductions while buying goods and services with VAT
4. it seems that from the point of view of budget revenues generation capabilities alternative of a 6% unified tax (and compliance with VAT obligations) applied to all categories of SME would be more reasonable, while still providing simplified, unified tax regime, which would be preferential in comparison with normal PIT or CIT taxation scheme.

To conclude, it seems that proposed form of the Chapter 98 should undergo further improvement before new Tax Code is read in the Verhovna Rada for the second time. It appears necessary condition if proposed legislation is to result in expected positive influence on the creation of favorable environment for SME development in Ukraine. It is worth underlying that special tax treatment for SME may be needed in Ukraine. However, such measures should be designed in a way that preferential treatment for small firms would not prevent them from further development. The solution would be building less progressive and less distortional simplified tax system for the SME.